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Commercial Banks in Microfinance:
New Actors in the Microfinance World

Little has been written about the role of commercial banks in micro-finance. The reason is simple: there has been little to tell because commercial banks have been so notably absent from this field. In their absence, a large number of non-governmental organizations (NGOs) and other specialized institutions have created financial technologies that serve increasing numbers of the poor and sustain loan repayment rates that are not only competitive with traditional commercial banks but also offer profits without subsidies.

Now commercial banks in developing countries have begun to see micro-finance not only as a valuable public relations tool but a profitable venture and are beginning to examine the micro-finance market. At the same time, some NGOs have transformed themselves into regulated banks. Today's micro-finance landscape is being shaped by regulated micro-finance banks created from these two different backgrounds, each offering their own distinct strengths and weaknesses.

In November 1996, the U.S. Agency for International Development (USAID) sponsored a conference to examine the expansion of banking services to micro-enterprises in the developing world. The first event of its kind, the conference brought together bankers from 17 regulated financial entities in 16 developing countries to capture and share experiences, learn about each other's practices, and discuss obstacles. There were large, multi-service and state-owned banks and small, specialized banks and finance companies.

The purpose of this note is to share the findings of a survey of these banks that were presented in a study published by USAID last year (see citation). In this note, the word "banks" is used loosely to refer to commercial banks that participated in the conference.

Commercial banks in micro-finance

Bankers in large commercial banks typically mention the risk of default, high costs, and socio-economic and cultural barriers as the chief reasons that prevent their entry into micro-finance. They also face some internal constraints such as:

- **Institutional Commitment** - The foray of larger commercial banks into micro-finance is frequently dependent on a handful of visionary board members rather than based on an institutional mission.
- **Organizational structure** - Commercial banks find it difficult to integrate micro-finance within a larger bank culture and structure that is not geared toward a high volume, small loan size business. ·
- **Financial methodology** - Most commercial banks lack the financial methodologies to reach and retain low-income clients who require small amounts of capital. ·

- **Human resources** - Issues of recruitment, training, and performance-related incentives require specialized consideration and effort, because micro-finance operations are labor-intensive and require people special people skills. ·
- **Cost-effectiveness** - Traditional bank mechanisms and overhead structures make it difficult for banks to minimize processing costs, increase staff productivity, and rapidly expand micro-finance loan portfolios - efforts necessary to cover costs and earn profits. ·
- **Regulatory compliance** - Fulfilling reporting and regulatory requirements to reflect micro-finance operations calls for new procedures that both commercial banks and government regulators have yet to develop.

Despite these constraints, commercial banks have several organizational and structural features that can lend themselves to successful micro-finance operations:

- They are regulated institutions fulfilling conditions of ownership, financial disclosure and capital adequacy to help ensure prudent management;
- Many have the physical infrastructure, including branch networks, to enable them to reach a large number of micro-finance clients;
- They have well-established internal controls and administrative and accounting systems to keep of track large numbers of transactions;
- Their private capital ownership structures tend to encourage sound governance structures, cost-effectiveness, profitability, and sustainability; ·
- Access to their own source of funds (deposits and equity capital) free them from depending on scarce and volatile donor resources, and;
- The ability to offer loans, deposits, and other financial products make them attractive to micro-finance clients.

Key findings

Policy Environment

It was clear that countries experiencing substantial financial liberalization offered a far more promising opportunity for experiments in micro-finance than those under a regime of financial repression. The banks attending the conference (see table) largely operate in countries that have undertaken stabilization efforts in the late 1980s, and all but one have deregulated deposit and loan interest rates. These developments allowed banks to charge the relatively high interest rates on micro-loans and cover transaction costs, default risk, and the opportunity costs of funds thus, encouraging their entry into the micro-finance market.

High reserve requirements also pose an impediment to commercial banks entering micro-finance. The higher the reserve requirement, the less the deposit base available for on-lending and the lower the profits. The commercial banks from Latin America did not enter into micro-finance until the early 1990s when reserve requirements declined from around 50 percent to more modest levels of between 10-30 percent.

Management Commitment

In addition to a favorable policy environment, commitment to micro-finance at the highest levels of management and board of the bank is a necessary condition for successful micro-finance operations. The lack of strong commitment appears to explain in part the short life of the micro-finance program at the Standard Bank of South Africa and the stunted outreach in Ecuador's Banco del Pacífico, which after 23 years of operations in micro-finance has only 4,000 active loan clients.

Micro-finance methodologies are so different from conventional banking that they are generally not understood by most mid-level bank managers, and sometimes are considered a second-class activity. Moreover, in instances where the micro-finance program competes for resources and status with other divisions in the bank, it faces threats from within the institution. Thus, a strong and committed leadership to design, implement, and steer the development of the micro-finance operations is crucial.

Administrative Mechanism

Among the banks studied, four administrative structures were used to carry out micro-finance operations:

a. Fully independent retail centers, affiliated to the bank but with their own lending policies, staff, and information systems that report to the larger bank (Banco del Desarrollo's micro-finance subsidiary in Chile, the Unit Desa of Bank Rakyat Indonesia, and the Social Enterprise Program of the Bank of Nova Scotia in Guyana).
b. Lending through NGOs that, in turn, on-lend to micro-enterprise clients (Banco Wiese in Peru).
c. Semi-independent micro-finance units lending directly and/or specialized windows in each bank branch, staffed with a micro-finance credit officer. Administrative and financial functions are integrated into the larger bank (Banco Agrícola Comercial, El Salvador; Banco del Pacífico, Ecuador; and Financiera Familiar, Paraguay).
d. Fully integrated operations, wherein small business credit officers also handle microenterprise clients. All administrative, personnel, and financial systems are integrated. (Centenary Bank, Uganda; Multi-credit Bank, Panama; Caja de Ahorro y Crédito Los Andes and Bancosol, Bolivia).

Most of the commercial banks attending the conference offered micro-loans through a separate window or part of the branch office that handles only micro-finance clients. This separation allowed both the staff and clients to recognize the terms and differences between the traditional commercial banking services and micro-finance services. The study suggests a positive correlation between the degree of independence of the micro-finance unit and the scale of the operation.

Moreover, banks with specialized independent micro-finance units or subsidiaries found it easier to institute micro-finance lending policies, procedures, and methodologies and avoid interference from the larger bank culture. Perhaps the most dramatic example is Bank of Nova Scotia that operates a group-lending program in Guyana with loans mostly under US$300 under the umbrella of a large, sophisticated, foreign-owned commercial bank.

Start-up and funding sources

Typically, most banks cross-subsidized the micro-finance operations from their own resources to cover initial sunk costs and operating costs for a period of two to three years. Some banks, such as Bank Rakyat Indonesia and Centenary Bank (Uganda) benefited from donor-subsidized technical assistance. Others such as Family Finance Building Society (Kenya) also had access to donor funds for on-lending, although these amounts were less than 10 percent of their micro-finance portfolio). Few banks such as Caja Los Andes (Bolivia), National Development for Bank (Egypt), Financiera Familiar (Paraguay), and Workers Bank (Jamaica) received donor funds for onlending and to cover their initial operating costs.

The degree to which the larger banks used their deposit base to finance micro-finance portfolios depended largely on the opportunity costs of using deposits for this purpose compared with returns for other uses. For many, the ability to charge higher interest rates for micro-finance loans significantly closed this gap and made micro-finance lending an attractive alternative.

Cost Effectiveness

Although most of the micro-finance operations were profitable, the bankers generally considered the costs of microlending to be too high. While costs for micro-finance are higher than conventional banking, there are several strategies to reduce costs. For example, the smart card option of Financiera Familiar appeared to be an excellent cost-cutter for processing repeat loans. A similar approach by Caja Los Andes and Centenary Bank through the use of a credit line for repeat customers also seemed cost-effective.

Some banks may need to increase their interest rates to reflect the fact that micro-finance operations are more costly, but bankers often cite image or bad publicity problems associated with charging higher interest rates to poorer clients.

But the actual costs of micro-finance operations within commercial banks are unclear, especially when the operations are integrated into a larger structure. Until there is greater separation of costs in these institutions, and until banks with micro-finance operations feel free to share income and expense data, the question of whether or not micro-finance operations are costlier for traditional commercial banks than NGOs or specialized banks (such as BancoSol) will remain open.

Human Resource Management

Given the labor-intensive nature of micro-finance services, banks face a special challenge in the recruitment, training, and motivation of staff. Most banks at the conference hired micro-finance staff outside the bank and preferred young university graduates with little experience. This made them more receptive to the special mission and practices of the micro-finance program.

Performance-based incentives as remuneration for loan officers, a common practice in micro-finance institutions, can become a source of tension because of other (non-micro-finance) bank employees who do not receive these bonus remunerations. Some banks have managed this tension by ensuring that micro-finance staff salaries plus incentives do not exceed salaries of other bank employees. Others (Bank Dagang Bali, Banco Empresarial, National Development Bank) gave the same incentives to all bank staff which eliminated the potential for tension.

Financial Products and Services

There are some interesting departures and similarities in the savings and credit services offered by commercial banks from micro-finance NGOs.

Overall, the average loan size of the banks in the conference was less than US$1400. This loan size is larger than the average loan size reported by micro-finance NGOs. Moreover, loan maturities ranged from only one month to four years, with most banks offering loans with maturity dates beyond one year (longer than is characteristic of NGOs). Most banks offered individual loans rather than group loans. Few such as BancoSol, Banco Empresarial, and Bank of Nova Scotia in Guyana also have group loans. Banks that offer smaller loans rely more heavily on character references while banks with larger loans require clients to offer household goods or find cosigners as collateral.

Among the similarities between commercial banks and NGOs is the frequency of repayments. Bi-weekly, weekly, and even daily repayments characterize a number of the institutions in the conference. Also, like NGOs, these banks had very short processing times (between one to seven days) for micro-loans.

Unlike NGOs, all of the banks offered deposit services. Only four of the banks (Bank Dagang Bali, Bank Rakyat Indonesia, Standard Bank, and Workers Bank) had instituted explicit initiatives to attract very small depositors. However, all of the banks reported having small savings accounts with balances under US$500. Although Centenary Bank did not have a special strategy to reach small depositors, by lowering its minimum balance requirement to US$10 (compared to US$50 required by other Ugandan banks), it was able to attract a large number of small savers and had over 42,000 savings accounts with balances under US$500.

In sum, although all of the banks had instituted some micro-finance techniques and innovations, many still need to adjust their products, operating procedures, and loan prices to tailor their products and services and make them more suitable for micro-finance clients.

Role of Donors

The study also discussed the role of donors in facilitating the entry of commercial banks into micro-finance operations.

Donors can make an important contribution in improving the financial sector environment for commercial banks to enter into micro-finance. For example, donors can urge governments to eliminate repressive financial regulations, such as interest rate ceilings and burdensome reserve requirements or targeted credit schemes. These changes will help micro-finance lenders compete in open markets and cover operating costs, risks, and opportunity costs of capital.

Donors can help develop and encourage the adoption of prudential regulatory frameworks that recognize the special nature of micro-finance. High legal reserve requirements, burdensome reporting requirements, inappropriate criteria for loan portfolio classification and provisioning, restrictions on the volume of unsecured (non-collateralized) loans, and inappropriate operational cost ratios are some of the elements that need to be modified to suit micro-finance operations. Donors should support dialogues between banks providing micro-finance services and regulators to help educate supervisory authorities on the difference between micro-finance and traditional banking.

And finally, there is a useful but limited role for donors in supporting commercial banks entering micro-finance through funding and/or free technical assistance. But two important questions emerge from this flow of donor resources to commercial banks:

1. What is the most efficient instrument for subsidy? (cheap funds, guarantees, technical assistance, etc.) and
2. What is the most appropriate level of subsidy and how long should it be granted?

Link to table

This note is a synopsis of a study by Mayada Baydas, Douglas Graham, and Liza Valenzuela titled, *"Commercial Banks in Microfinance: New Actors in the Micro-finance World."* The study is available from Development Alternative Inc. 7250 Woodmont Avenue, Suite 200, Bethesda, MD 20814, USA; tel: (301) 718-8699; fax: (301)718-7968 or at http://www.mip.org on the web.

Institution & Country	Proportion of Loans in Micro-finance	Number of Micro-finance Loans	Outstanding Balance of Micro-finance loans	Avg. Outst Micro-loan/ GDP per capita	Number of Savings Accounts	Outstanding Savings Balance	Effective Interest Rate
Large, multi-service banks							
Banco Agricola Comercial, El Salvador	3.3%	9,305	$14.8M	2.27	50,459	$3.3M	n.a.
Banco del Desarrollo, Chile	100%	17,500	$17.6M	0.28	n.a.	n.a.	3.7%p.m.
Banco del Pacifico, Ecuador	2%	4,000	$4M	0.78	8,000	n.a.	57%p.a.
Bank of Nova Scotia, Guyana	9% (100% for subsidiary)	9,000	$1.2M	0.25	2,700	n.a.	25%p.a.
Banco Wiese, Peru	10%	4,760	$19M	1.89	n.a.	n.a.	41%p.a.
Bank Rakyat Indonesia, Indonesia	100% for Unit Desa program	2.4M	$1.6B	0.76	15.6M	$2.8B	32%p.a.
Multi-credit Bank, Panama	10%	1,450	$8.6M	0.23	1,750	$143.3M	32%p.a.
National Bank for Development, Egypt	3.7%	20,852	$13.5M	0.83	20,852	$1.7M	30%p.a.
Standard Bank, South Africa	Negligible	226	$138,000	0.20	287,786	$20M	50%p.a.
Workers Bank, Jamaica	New credit program	177	$3.3M	8.44	n.a.	$51M	n.a.
Small, specialized banks							
BancoSol, Bolivia	100%	57,745	$30.2M	0.67	45,911	n.a.	48%p.a.
Bank Dagang Bali, Indonesia	83%	13,133	$43.1M	3.73	344,619	$105M	30%p.a.
Banco Empresarial, Guatemala	11%	840	$2M	1.98	20,000	$33M	30%p.a.
Caja de Ahorro y Crédito Los Andes, Bolivia	100%	17,854	$8.62M	0.62	360	$1.2M	3.5%p.m.
Centenary Bank, Uganda	83%	3,900	$5.8M	7.80	60,900	$9.3M	46%p.a.
Family Finance Building Society, Kenya	85%	6,000	$1.4M	0.93	22,500	$5.8M	34%p.a.
Financiera Familiar, Paraguay	20%	4,658	$4.5M	0.61	1,100	$13.5M	6%p.m.
Panabo Rural Bank, Philippines	27%	1,602	$1.61M	1.06	10,019	$34.6M	40%p.a.